PEGASYSTEMS INC

FORM 10-K
(Annual Report)

Filed 03/31/97 for the Period Ending 12/31/96

Address	ONE ROGERS STREET CAMBRIDGE, MA 02142-1209
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Industry	Software
Sector	Technology
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PEGASYSTEMS INC

FORM 10-K
(Annual Report)

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Address	101 MAIN ST
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Telephone	617-374-9600
CIK	0001013857
Industry	Software & Programming
Sector	Technology
Fiscal Year	12/31

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 1996

Commission File No. 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts (State or other jurisdiction of incorporation or organization)	4-2787865 (IRS Employer Identification No.)
101 Main Street Cambridge, MA (Address of principal executive offices)	02142-1590 (zip code)

(617) 374-9600
(Registrant's telephone number including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: None
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Common Stock, $.01 par value per share

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark if disclosure of delinquent filers pursuant to

Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

As of March 24, 1997, the aggregate market value of the Registrant's voting stock held by non-affiliates of the Registrant was approximately $589.7 million (without admitting that any person whose shares are not included in determining such value is an affiliate).

There were 28,418,800 shares of the Registrant's common stock, $.01 par value per share, outstanding on March 24, 1997.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Definitive Proxy Statement for its 1997 Annual Meeting of Stockholders to be held on May 13, 1997 (the "1997 Proxy Statement") are incorporated by reference into Part III of this Form 10-K and portions of the Registrant's Annual Report to Stockholders for the Registrant's fiscal year ended December 31, 1996 (the "1996 Annual Report") are incorporated by reference into Part II and Part IV of this Form 10-K. With the exception of the portions of the 1997 Proxy Statement and the 1996 Annual Report expressly incorporated into this Form 10-K by reference, such documents shall not be deemed filed as part of this Form 10-K.

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PART 1

PART I

Item 1 BUSINESS

Pegasystems develops customer service management software to automate customer interactions across transaction-intensive enterprises. Many of the world's largest banks, mutual funds and credit card organizations use the Company's solutions to integrate, automate, standardize and manage a broad array of mission-critical customer service activities, including account set-up, record retrieval, correspondence, disputes, investigations and adjustments. The Company's systems can be used by thousands of concurrent users to manage customer interactions and to generate billions of dollars a day in resulting transactions. Work processes initiated by the Company's systems are driven by a highly adaptable "rule base" defined by the user-organization for its specific needs. The rule base facilitates a high level of consistency in customer interactions, yet drives different processes depending on the customer profile or the nature of the request. The Company's open, multi-tier, client/server systems operate on a broad variety of platforms, including UNIX, Windows/NT and IBM/MVS. The Company offers consulting, training and support services to facilitate the use of its solutions.

Industry Background

Intensifying competition is forcing businesses to reduce costs while focusing on customer service management as an important means of differentiation. Many types of businesses are increasingly recognizing customer interactions as a critical opportunity to solidify and expand customer relationships. Due to the volume and precise nature of their transactions, it is especially critical for financial services organizations to implement cost-effective systems to manage customer interactions accurately and efficiently.

Providing high quality, cost-effective customer service management is complex. Organizations with global operations must be able to manage customer interactions in different languages, time zones, currencies and regulatory environments. The challenge is magnified as the product offerings of an organization increase and organizations are combined. Work processes occasioned by a single customer interaction often involve multiple departments within an organization, which may have different priorities and service standards, and may involve a variety of different computer systems. Customers may contact an organization through various means, including telephone, facsimile, the Internet or in person. The organization must be able to respond in a timely, accurate and consistent fashion or risk customer defection.

Historically, in attempting to meet demand for new customer management software systems, organizations have faced a choice between building custom systems or purchasing third party systems. Building custom systems or modifying third party systems can be slow and costly and has often led to isolated, departmentalized solutions. Traditional third party systems are often inflexible, requiring organizations to conform their work processes to the system, rather than vice-versa. Neither custom nor third party solutions have generally accommodated an organization's need to evolve or expand operations without significant programming effort. Moreover, neither has had the high volume transaction processing or integration capabilities necessary to support the comprehensive customer interaction requirements of large organizations. Today, organizations need flexible, scalable customer service management solutions that can be implemented on an enterprise-wide basis to facilitate consistent, cost-effective customer service management.

The Pegasystems Solution

The Company's solutions integrate, automate, standardize and manage on an enterprise-wide basis a broad array of mission-critical customer interactions for financial services organizations, including account set-up, record retrieval, correspondence, disputes, investigations and adjustments. Pegasystems' solutions provide a service backbone that drives intelligent processing and seamlessly integrates an organization's geographically dispersed and product specific service operations and isolated computer systems. By bridging these "islands of automation" within large organizations, the Company's solutions increase the efficiency of service representatives and enable organizations to address multiple customer needs during a single contact.

The Company's customer service management solutions offer the following advantages:

Flexibility and Consistency. The Company's solutions are based on rules defined by the user-organization which drive various types of processing depending on such factors as the content of the customer request, the profile of the customer, the organization's policies and procedures and the authority or qualifications of the customer service representative. By modifying its rule base, an organization can evolve its processing to address the competitive requirements of its business without costly and time consuming reprogramming. Significantly, the rule base feature of the Company's systems permits an organization to establish consistent standards yet interact differently with different segments of its customer base and thereby "mass customize" its services.

Scalability and Robust Functionality. The scalability of the Company's multi-tier client/server architecture allows an organization to add branches or departments easily to new or existing servers without performance degradation. Organizations currently entrust the Company's systems with the storage and management of data relating to hundreds of millions of financial transactions. The Company's systems can be used by more than 4,000 concurrent users to manage customer interactions and to process accurately and securely transactions involving billions of dollars a day that result from those interactions.

Ease-of-Use. The Company's client software application, PegaVIEW-ACE, increases the effectiveness and productivity of customer service representatives by providing them with a flexible graphical user interface and processing capabilities that leverage the power of client/server desktop computers. The Company's solutions allow customer service representatives to focus on delivering superior customer service, rather than on mastering the protocols and procedures of multiple applications.

Integration Capabilities. The Company's open architecture permits its solutions to be integrated with a wide variety of other applications and technologies, including industry standard relational database management systems, advanced telephony equipment and diverse storage media (including magnetic, optical, tape and microfilm). The Company's solutions also support the message formats of major financial transaction networks such as the SWIFT international funds network, the Federal Reserve's Fedwire system and the VISA and MasterCard networks.

Multi-Platform Server Support. The Company's solutions feature a common software code base which, in addition to facilitating maintenance and enhancement development efforts, simplifies the support of multiple platforms. The Company's solutions are designed to run on a broad range of computer operating systems including IBM's MVS/CICS and AIX/UNIX systems, Digital Equipment Corporation's VMS and UNIX systems, Microsoft's Windows/NT system and Sun Microsystems' Solaris UNIX system.

Improved Efficiency of Customer Service Representatives. Pegasystems' solutions actually perform work, rather than simply track a customer service representative's tasks. Variable data elements (for example, date, amount, customer, account) automatically route service requests and invoke system processes, depending on an organization's rule base. This feature allows customer service representatives to focus on revenue enhancing opportunities, such as cross-selling, and other matters requiring personal attention. When service representative involvement is required during a customer interaction, the Company's solutions provide pertinent, consolidated information to guide the service representative. Savings are realized through reduced talk time, fewer manual processes and less rework.

Business Strategy

Pegasystems' objective is to become the leading provider of mission-critical client/server customer service management software to organizations performing a high volume of complex interactions with demanding customers. To achieve this objective, the Company is pursuing the following strategies:

Leverage Strength in Financial Services Market. Pegasystems provides customer service management solutions to many of the largest financial services organizations in the world. The Company is seeking to expand its business with these organizations through a sales group focused on marketing the Company's products and services to other business operations of these organizations. The Company is also leveraging its relationships and expertise with large financial services organizations to penetrate the medium-sized financial services market.

Target Other Markets. Pegasystems believes that the insurance, telecommunications, medical, public utilities, retail and other markets have similar customer service management needs and that the Company's core technology is readily adaptable to these additional markets. The Company is exploring these additional markets, and if appropriate, expects to develop the necessary industry specific extensions of its core technology and hire or otherwise gain access to personnel with expertise in such markets.

Increase Sales and Support Efforts. Pegasystems intends to establish additional sales and support offices and to increase significantly its domestic and international direct sales forces. In addition, the Company plans to develop further its relationships with financial transaction processors and consulting firms through which the Company's products can be distributed and implemented.

Develop Standard Product Templates. The Company recently commenced licensing standard product templates that give organizations an advanced starting point for configuring their work processes. The Company intends to continue to develop and market standard product templates for financial services organizations, including templates for outbound telemarketing, collections and account set-up. The Company believes that these templates will facilitate more rapid implementation of the Company's solutions and will be a cost-effective way to address the needs of smaller organizations.

Reduce Implementation Time. The Company is continuing to refine its PegaSTAR consulting methodology, an approach to the reengineering of an organization's work processes that facilitates more rapid implementation of the Company's customer management systems and continued evolution of such systems by an organization's personnel after initial implementation. This methodology complements the Company's standard product templates in reducing the time required to implement the Company's systems.

Maintain Technological Leadership Position. Pegasystems is continuing to develop and invest in its technology. Current development efforts include the development of tools to facilitate the configuration by an organization of its customer service management system, the integration of the Company's products with additional databases, the Internet and intranet systems and support of emerging technical and workflow standards.

Technology

The Company's technology is designed to optimize the performance of mission-critical, customer service management processes over a variety of computer platforms, networks and databases. Pegasystems' solutions have the following key technological attributes:

"Any-Call, Any-Time, Anywhere" Information Management. Effective customer response requires up-to-date information about the customer relationship, regardless of how, why, when or where the customer contacts the organization. Pegasystems' customer service management systems centralize core customer information to facilitate global access.

Multi-tier, Dynamic Distributed Processing. Although the Company's systems are currently used primarily in a two-tier client/server environment, they are also designed to run in an advanced, highly scalable three-tier environment. In traditional three-tier client/server environments, the user interface, the application code, and the data are segregated onto separate tiers. In the Pegasystems three-tier client/server environment, the application code, the rule base and selected data are replicated on both the central and satellite tiers so that processing may occur on either the central server or the distributed satellite servers to minimize network traffic and enhance performance. The rule base determines the optimal location for processing to occur based on the nature of the work required and the data involved. Rule base changes are replicated across the organization's central and satellite servers to facilitate consistent processing by all parts of the organization.

Inherited Workflow. Pegasystems solutions maintain organizational consistency while providing the flexibility needed for mass customization. The rule base of the Company's systems may be defined so that certain processes are standardized across an organization while others may be superseded or supplemented by "local" rules tailored to the specific requirements of groups within the organization.

Resiliency. Fallback options are provided to deal with hardware or network failure. For example, in a three-tier environment, the PC client can bypass a failed satellite server and connect directly to the central server. The Company is presently working to enhance its systems so that should a failure occur at the central server, each satellite server's replicated code and rule base could support continued processing, with "store and forward" capabilities to automatically re-synchronize the central server when it resumes operation.

Platform Independence. Recognizing that organizations often use a variety of computer platforms, Pegasystems provides technology alternatives by supporting a range of mainframes, minicomputers, PC networks and interface devices. While the Company offers its advanced Windows-based PegaVIEW-ACE application for the desktop, the Company's server applications can also drive "dumb terminals," allowing organizations to preserve their investments in legacy networks.

Internet and Intranet Access. Pegasystems' solutions use the Internet-based HTML (Hypertext Markup Language) to define display attributes for its PegaVIEW-ACE graphical user interface, leveraging logic and presentation rules between PegaVIEW-ACE and Internet/Intranet workflows. Pegasystems' rules dynamically create HTML forms, menus and displays, thereby facilitating interaction with the Internet. Pegasystems is a Netscape Development partner and supports the Netscape Commerce Server interface.

Interfacing With Other Systems. Pegasystems' open architecture permits integration with a wide variety of other applications and networks, including relational databases, legacy systems accessed through IBM 3270 emulation, and messaging protocols. The Company offers a Universal Application Programming Interface (API) that allows an organization's custom software to be integrated with the Company's applications without the need to modify the Company's core application code. Pegasystems' solutions also integrate with other applications, accounting systems and imaging products. The Company's systems support the message formats of major financial transaction networks, such as the SWIFT international funds network, the Federal Reserve's Fedwire system and the VISA and MasterCard networks.

Storage Options. Data storage flexibility is important to the Company's customers, and the Company's software uses an innovative object-oriented approach that dynamically maps data according to the type of workflow. Versions of the Company's systems designed to run on Windows/NT can store customer service request data in Microsoft's SQL Server relational database, and the Company has developed similar compatibility in the Windows/NT, RS 6000/AIX and Sun Solaris environments for databases from Oracle Corporation.

Products

The Company's products employ a consistent architecture and support the following customer service management functions:

Receiving. Organizations receive service requests by telephone, mail, facsimile, or personal contact. Customer service representatives enter details of incoming requests into PegaVIEW-ACE, the Company's easy-to-use, graphical user interface. Alternatively, electronic service requests received from various networks and systems, such as the SWIFT network, Fedwire system, and the VISA and MasterCard networks are entered directly into the Company's system. The Company's systems also support direct electronic access by customers through PCs, Internet browsers and voice response units. In all cases, the service request automatically initiates appropriate processing.

Routing. As processing steps are completed, the Company's systems categorize and queue the request either for automatic or manual processing. Productivity-based load leveling and dynamic prioritization ensure high performance and responsiveness. As work is processed, each service representative's "work-list" is automatically updated in real time. The systems monitor each service request for conformance to the organization's timeliness standards, automatically increasing priority and generating warnings based on the service standards of the organization.

Researching. The Company's systems determine when more information is needed, where to locate it, and how to retrieve it from databases or other repositories. Pegasystems' rule-driven processing automatically extracts relevant data, directs it to the customer service representative or customer, links it to the work, and keeps it readily accessible. The Company's systems can access information from multiple data sources, whether maintained by the Company's systems or third party systems.

Responding. The Company's systems facilitate communications by an organization with its customers by combining user-defined templates and specific customer information to create personalized correspondence. When appropriate, service representatives may further refine message content before forwarding by mail, facsimile or electronic transmission, and may attach images of statements, checks and other data. Follow-up communications are automatically composed, customized and sent. Sensitive correspondence can be queued for online review before release, and the systems create a permanent audit trail of all customer communications.

Resolving. Concluding a piece of work involves application of the organization's rules for resolving a request or stepping the customer service representative through the process when human judgment is required. Resolution also includes the creation of transactions, transmission to production systems, management of financial adjustments, posting of service charges, updating of general ledger accounts and synchronization of multiple item requests.

Reporting. Data automatically collected by the Company's systems enables an organization to analyze service representative efficiency and determine needs for service representative training or changes to work processes. The Company's systems produce reports, graphical output and feeds to spreadsheets illustrating the volume and status of customer requests, the productivity of customer service representatives and service levels with specific customers.

The Company offers a number of different products, each with components and features designed to address particular business areas, but all sharing core technology and adaptable rule-driven processing:

PegaCARD manages credit and debit card customer service operations by supporting a wide variety of interactions with cardholders and merchants, including simple inquiries (for example, balances or credit limits), customer requests (address changes, additional cards, credit line increases) and problem management (disputes, chargebacks, fraud, financial adjustments, penalties). Automated features include processing of electronic chargeback messages and images from the MasterCard and VISA networks. PegaCARD allows service representatives to move seamlessly among multiple back-end accounting systems without having to be familiar with the different protocols of each system.

PegaCLAIMS manages corporate and wholesale banking customer service by supporting a broad spectrum of customer interactions, including inquiries (product terms, rates), customer requests (account data changes, duplicate copies), and problem management (research, financial adjustments). PegaCLAIMS processes customer service interactions relating to money transfers, securities movement and control, global custody, trade services, foreign exchange and cash management, and features electronic message routing, SWIFT processing and interbank financial compensation management.

PegaSHARES manages customer service for transfer agents, brokers, dealers, shareholder servicers and mutual fund managers by supporting inquiries (share balances, net asset values, transactions), customer requests (account changes, copies of statements) and problem resolution (incorrect purchases, monetary adjustments). Automated features include share transfer accounting, literature fulfillment and securities processing compliance.

PegaTRACE facilitates retail banking and check clearing customer service by processing inquiries (account balances, fees), customer requests (copies of statements, account transfers) and problem management (research, financial adjustments). PegaTRACE securely manages the suspense accounts that major organizations use to control the flow of accounting entries. Additional features include integration with check clearing systems, suspense ledger management, multi-debit/credit adjustments, and electronic check presentment (ECP) interfaces.

PegaSEARCH and PegaINDEX manage high volumes of archived data, such as check information, contained on multiple types of storage media including magnetic disk, optical disk and magnetic tape silos. These systems are designed for organizations that process tens of millions of checks per day and require seven years of archived check data.

PegaPRISM and PegaREELAY are used by customer service representatives to retrieve images, view them on a PC and correlate them with specific customer service requests. PegaREELAY is a specialized image retrieval product that automates request processing of reel microfilm.

PegaVIEW-ACE (the Advanced Client Environment) is a graphical client application designed for use with the Company's server applications to increase the effectiveness and productivity of customer service representatives. PegaVIEW-ACE organizes customer data to facilitate service representative effectiveness and supports graphical methods to view and enter information.

Product Pricing

The Company's systems are licensed to organizations under agreements requiring the payment of fees, typically in monthly installments, over the term of the agreement. The amount of the license fee is based on various factors, including the number of concurrent users, the functionality of the system, the number of servers on which product is installed, and the scope of business usage. Typical recent individual system licenses have provided for the payment of monthly installments of between $5,000 and $50,000. Some organizations receive discounts for licensing multiple systems. The monthly license payments generally begin once a system is installed and accepted. The term of such licenses is typically five years, subject to automatic renewal at the organization's option.

Services

Pegasystems' Reengineering and Client Services Group, which as of December 31, 1996 was comprised of 68 people located in the Company's six offices, provides consulting, training and customer support.

Consulting Services. The Company works with its customers during and after system installation to reengineer customer workflows to leverage the capabilities of the Company's systems. Using an installation approach based on its PegaSTAR (the Pegasystems Structured Technique for Analysis and Reengineering) methodology, the Company's consultants assist customers in six major areas - analysis, data collection, process definition, configuration, piloting and measurement. The Company encourages team building and transfer of knowledge from its consultants to an organization's staff through an interactive co-production methodology. Pegasystems and its customers work together to design, document and tailor the system's rule base to the customer's organization. Pegasystems' goal is to empower its customers' staffs with the knowledge and confidence to operate, refine and evolve their systems.

Training. The Company offers training programs for those persons within the customer organization responsible for evolving the rules that drive the various processes related to customer interactions. Pegasystems also organizes periodic user group meetings enabling customers to exchange ideas, learn about product directions and influence Pegasystems' development process.

Maintenance and Support. Pegasystems provides comprehensive maintenance and support services, which may include 24 hours a day, 7 days a week customer service, periodic preventative maintenance, documentation updates and new software releases.

Each organization which licenses the Company's systems is required to enter into a maintenance contract providing for the payment to the Company of a monthly maintenance fee over the term of the related license agreement equal to approximately 18% of the license fee. The Company's maintenance agreements typically obligate Pegasystems to provide up to a specified number of hours of consulting and support. Organizations seeking additional consulting and support services are generally charged an incremental fee ranging between $90 and $170 per hour.

Customers

During 1994 Chemical Bank accounted for 16.8% of the Company's consolidated revenue. Chemical Bank also accounted for 12.6% of the Company's 1995 consolidated revenue. In 1995 Citibank and Household Credit Services accounted for 16.2% and 14.9%, respectively, of the Company's consolidated revenue. In 1996, Bank of America, Chase Manhattan Bank and Fleet Bank accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue.

Pegasystems provides robust and scalable customer service management solutions that can support thousands of concurrent users based in multiple countries, speaking different languages, and working with different currencies. A representative list of the Company's major customers and the uses to which they apply the Company's products is shown below:

Advanta Services Corporation - Credit card operations, including telephony center, correspondence generation, collections, and dispute and chargeback processing.

Banco Popular de Puerto Rico - Retail service center automation, check research, and consumer loan inquiry and service.

Bank of America - Retail/check customer service and research, automation of branch support centers. Institutional funds transfer and foreign exchange customer service for U.S. and European operations. Credit and debit card correspondence, and dispute and chargeback service processing.

Bank of Ireland - Retail/check clearings and research, automation of branch support centers, and exception/credit item review and verification.

Banque Nationale de Paris - Institutional funds transfer service, research, and archive.

Barclays Bank PLC - Institutional funds transfer and foreign exchange customer service for international operations. Credit card (merchant and individual) service including telephony center, correspondence, and dispute and chargeback processing.

Cedel Bank - Global custody and securities movement customer service.

Citibank - Global funds transfer and foreign exchange customer service. Check-related customer service and research. Domestic MasterCard and Visa service including image integration, correspondence, and dispute and chargeback processing.

Colonial Group - Mutual fund customer service supporting telephony center and correspondence.

Federal Reserve Banks of Boston and San Francisco - Check processing customer service, suspense ledger management, research, adjustment, and archive.

Fidelity Investments - Mutual fund customer service supporting telephony center and correspondence.

First Chicago NBD - Retail/check customer service and research. Wholesale banking, funds transfer, check, corporate lockbox, and interbank compensation service for global operations.

Franklin Templeton Group - Mutual fund customer service supporting telephony center, correspondence, and research.

Household Credit Services - Credit card service including telephony center, correspondence, dispute, and chargeback processing. Private label customer service for major retailers.

Marine Midland Bank - Institutional funds transfer customer service.

Mellon Bank Corporation - Retail/check customer service, research, and archive. Wholesale, institutional, cash management, and corporate lockbox customer service.

Prudential Securities - "All-in-one" account support and service for brokerage, credit, and clearing transactions.

Trans Union Corporation - Credit bureau data-management customer service for institutional customers and real estate property appraisal processing.

Sales and Marketing

The Company markets its software and services primarily through a direct sales force. As of December 31, 1996, the Company's sales force consisted of a total of fifteen salespersons in the Company's domestic and foreign offices. The Company intends to increase substantially the size of its sales force. In addition, the Company is seeking to enhance the productivity of its direct sales force by hiring additional support personnel to assist with the sales, marketing and technical requirements of the Company's complex and lengthy sales cycle. To achieve significant revenue growth in the future, it will be necessary for the Company both to increase the size and to enhance the productivity of its direct sales force. Competition for qualified sales personnel is intense and there can be no assurance that the Company will be able to attract such personnel. If the Company is unable to hire additional qualified sales personnel on a timely basis, the Company's business, operating results and financial condition could be materially and adversely affected.

The Company has recently begun to develop an indirect distribution channel by entering into an agreement with First Data Investor Services Group, Inc., under which the Company's PegaSHARES product will be integrated with a shareholder servicing product distributed by First Data. In addition, the Company has established a joint marketing relationship with Sun Microsystems. In the future, the Company may also market and sell its products through value added resellers (VARs) and systems integrators. There can be no assurance, however, that the Company will be able to attract and retain VARs, system integrators and other third parties that will be able to market and sell the Company's products effectively.

To support its sales force, the Company conducts marketing programs which include trade shows, public relations and seminars. Sales leads are also generated by the Company's consulting staff, VARs and other third parties.

In 1994, 1995 and 1996, international sales represented 24.2%, 10.5% and 17.7%, respectively, of the Company's total revenue. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations" incorporated herein by reference from the 1996 Annual Report.

Product Development

Since its inception, the Company has made substantial investments in product development. The Company believes that its future performance depends on its ability to maintain and enhance its current products and develop new products. The Company's product development priorities include (1) creating tools to enable organizations to configure more easily their customer service management systems; (2) integrating the Company's products with the Internet for customer self-service and with intranet systems for departmental service; (3) developing standard Application Programming Interfaces that allow other client workstation and server applications to interoperate with the Company's systems; and (4) enhancing existing interfaces between the Company's systems and popular applications such as e-mail and spreadsheets.

In 1994, 1995 and 1996 the Company's research and development expenses were approximately $5.4 million, $7.1 million and $8.2 million, respectively.

Competition

The customer service management software market is intensely competitive and subject to rapid change. Competitors vary in size and in the scope and breadth of the products and services offered. The Company encounters competition primarily from internal information systems departments of potential or current customers that develop custom software. The Company also competes with: (1) software companies that target the customer interaction or workflow markets such as Remedy Corporation, Scopus Technology, Inc. and The Vantive Corporation; (2) companies that target specific service areas such as DST Systems Inc. and First Data Corp.; and (3) professional services organizations such as Andersen Consulting that develop custom software in conjunction with rendering consulting services. In addition, the Company expects additional competition from other established and emerging companies, including Oracle Corporation and SAP AG, as the market continues to develop and expand. Increased competition may result in price reductions, less beneficial contract terms, reduced gross margins and loss of market share, any of which could materially and adversely affect the Company's business, operating results and financial condition.

The Company believes that the principal competitive factors affecting its market include product features such as adaptability, scalability, ability to integrate with other products and technologies, functionality and ease-of-use, the timely development and introduction of new products and product enhancements, as well as product reputation, quality, performance, price, customer service and support, and the vendor's reputation. Although the Company believes that its products currently compete favorably with regard to such factors, there can be no assurance that the Company can maintain its competitive position against current and potential competitors.

Many of the Company's competitors have greater resources than the Company, and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards, or to changes in customer requirements or preferences. Many of the Company's competitors can devote greater managerial or financial resources than the Company can to develop, promote and distribute customer service management software products and provide related consulting, training and support services. There can be no assurance that the Company's current or future competitors will not develop products or services which may be superior in one or more respects to the Company's or which may gain greater market acceptance. Some of the Company's competitors have established or may establish cooperative arrangements or strategic alliances among themselves or with third parties, thus enhancing their abilities to compete with the Company. It is likely that new competitors will emerge and rapidly acquire market share. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not materially and adversely affect its business, operating results and financial condition.

Intellectual Property and Licenses

The Company relies primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect its proprietary rights. The Company also has one patent application pending in the United States relating to the architecture of the Company's systems. While the Company believes that its pending patent application relates to a patentable invention, there can be no assurance that such patent application or any future patent application will be granted or that any patent relied upon by the Company in the future will not be challenged, invalidated or circumvented or that rights granted thereunder will provide competitive advantages to the Company. Moreover, despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company's products or to obtain the use of information that the Company regards as proprietary. In addition, the laws of some foreign countries do not protect the Company's proprietary rights to as great an extent as do the laws of the United States. There can be no assurance that the Company's means of protecting its proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology.

The Company is not aware that any of its products infringes the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. The Company expects that software product developers will increasingly be subject to infringement claims as the number of products and competitors in the Company's industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition.

From time to time, the Company licenses software from third parties for use with its products. The Company believes that no such license agreement to which it is presently a party is material and that if any such license agreement were to terminate for any reason, the Company would be able to obtain a license or otherwise acquire other comparable technology or software on terms and on a timetable that would not be materially adverse to the Company.

Employees

As of December 31, 1996, the Company had a total of 220 employees, of whom 178 were based in the United States and 42 were based in Europe. Of the total, 84 were in research and development, 68 were in consulting and customer support, 47 were in sales and marketing, and 21 were in administration and finance. The Company's future performance depends in significant part upon the continued service of its key technical, sales and marketing and senior management personnel and its continuing ability to attract and retain highly qualified technical, sales and marketing and managerial personnel. Competition for such personnel is intense and there can be no assurance that the Company will be successful in attracting or retaining such personnel in the future. None of the Company's employees is represented by a labor union or is subject to a collective bargaining agreement. The Company has not experienced any work stoppages and considers its relations with its employees to be good.

Item 2 FACILITIES

Pegasystems' principal administrative, sales, marketing, support, and research and development operations are located in a 35,000 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in March 1999, subject to the Company's option to extend the term for up to eight additional years. The Company also leases offices in New York, New York, Chicago, Illinois, Dallas, Texas, San Francisco, California, Reading, United Kingdom and Paris, France pursuant to leases expiring between June 1997 and July 2006. The Company believes that additional or alternative space will be available in the future on commercially reasonable terms as needed.

Item 3 LEGAL PROCEEDINGS

The Company is not a party to any material pending litigation or other legal proceedings.

Item 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of fiscal 1996 there were no matters submitted to a vote of security holders.

EXECUTIVE OFFICERS OF THE REGISTRANT

The names of the Company's executive officers and certain information about them are set forth below as of December 31, 1996:

Name	Age	Position(s) and Office(s) Held
Alan Trefler	40	President, Clerk and Director
Clifford R. Balzer	46	Vice President of Reengineering and Client Services
Eugene A. Bonte	46	Vice President of Market Strategy and Delivery
Joseph J. Friscia	41	Vice President of Sales and Marketing
Kenneth W. Olson	46	Vice President of Technical Development
Michael R. Pyle	42	Vice President of Applications Development
Ira Vishner	43	Vice President of Corporate Services, Treasurer, Chief Financial Officer and Director

Executive officers of the Company are elected by the Board of Directors on an annual basis and serve until the next annual meeting of the Board of Directors and until their successors have been duly elected and qualified. There are no family relationships among any of the executive officers or directors of the Company.

Alan Trefler, a founder of the Company, has served as President and Clerk and has been a director since the Company's organization in 1983. Prior thereto, he managed an electronic funds transfer product for TMI Systems Corporation, a software and services company. Mr. Trefler holds a degree in economics and computer science from Dartmouth College.

Clifford R. Balzer joined the Company in December 1995 as Vice President of Reengineering and Client Services. From January through November 1995, he was a Senior Consultant for Arthur D. Little, a research and consulting firm. From July 1990 through January 1995, Mr. Balzer was employed as a Director of U.S. Consulting by DMR Group, Inc., an international consulting firm. Mr. Balzer holds a B.A. from Kansas Wesleyan University and an M.B.A. from Fordham University.

Eugene A. Bonte joined the Company in April 1996 as Vice President of Market Strategy and Delivery. He was a founder of Object Design, Inc., a developer of object database management systems and tools, where he served as Vice President from August 1988 through September 1995 and was responsible, at different times, for marketing, corporate development and product management. Mr. Bonte holds a B.A. from The Johns Hopkins University and an M.B.A. from the Harvard Business School.

Joseph J. Friscia joined the Company in 1984 to establish its New York office and has served as Vice President of Sales and Marketing since 1987. Prior to joining the Company, he worked as a money transfer operations manager with Bankers Trust Company and J. Henry Schroder Bank and Trust Company. Mr. Friscia holds a B.A. from Long Island University and an M.B.A. from Adelphi University.

Kenneth W. Olson, a founder of the Company, has served as Vice President of Technical Development since 1983. Prior thereto, he managed the development of specialized computer systems for large-volume transaction processing for TMI Systems Corporation. Mr. Olson holds an S.B. in Humanities and Sciences from the Massachusetts Institute of Technology.

Michael R. Pyle joined the Company in 1985 as an application development manager and has been Vice President of Applications Development since 1990. Mr. Pyle holds a B.C.S. from the CS College in London. Prior to joining the Company, Mr. Pyle worked in Europe and the United States developing and deploying large-scale communications systems for the financial and commercial sectors.

Ira Vishner, a founder of the Company, has served as Vice President of Corporate Services, Treasurer and Chief Financial Officer of the Company since 1983 and has been a director since 1994. Prior to 1983, he worked in the executive offices of TMI Systems Corporation where he was responsible for corporate planning, financial analysis and product marketing. Mr. Vishner holds an S.B. in Mathematics from the Massachusetts Institute of Technology.

CERTAIN STATEMENTS FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The Company, desiring to avail itself of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995, wishes to caution readers that the following important factors, among others, in some cases have caused and in the future could cause the Company's actual results to differ materially from those expressed in forward-looking statements made by or on behalf of the Company in filings with the Securities and Exchange Commission, press releases and oral statements.

RISK FACTORS

Potential Fluctuations in Quarterly Results; Seasonality

The Company's revenue and operating results have varied considerably in the past, and are likely to vary considerably in the future. Such fluctuations may be particularly pronounced because a significant portion of the Company's revenue in any quarter is attributable to product acceptances or license renewals by a relatively small number of customers, and reflects the Company's policy of recognizing license fee revenue upon product acceptance or license renewal in an amount equal to the present value of the total committed license payments due during the initial license term or renewal period, as the case may be. Product acceptance is preceded by an implementation period, typically ranging from three to six months but in some cases significantly longer, and by a lengthy sales cycle. The Company's sales cycle is subject to a number of significant risks over which the Company has little or no control, including customers' budgeting constraints and internal authorization reviews. Product implementation may be delayed for a variety of reasons including unforeseen technical problems and changes dictated by the customer in the scope or schedule of the implementation. Other factors contributing to fluctuations in the Company's revenue and operating results include changes in the level of operating expenses, demand for the Company's products and services, the introduction of new products and product enhancements by the Company and its competitors, competitive conditions in the industry and general economic conditions. The Company budgets its product development and other expenses anticipating future revenue. If revenue falls below expectations, the Company's business, operating results and financial condition are likely to be materially and adversely affected because only a small portion of the Company's expenses vary with its revenue. As a result, the Company believes that period-to-period comparisons of its operating results are not necessarily meaningful and should not be relied upon to predict future performance. There can be no assurance that the Company will be able to maintain profitability on an annual or quarterly basis.

The Company's business has experienced and may continue to experience significant seasonality. In recent years the Company has recognized a greater percentage of its revenue in its third and fourth quarters than in the first and second quarters due to the Company's sales commission structure and the impact of that structure on the timing of product acceptances and license renewals by customers. This pattern is reinforced by the Company's maintenance contracts, which entitle customers to, among other things, a fixed number of hours of service per calendar year. Once the annual allotment of service hours is exhausted, customers pay for additional services on an hourly basis, typically resulting in higher services revenue in the Company's second, third and fourth quarters.

Due to the foregoing factors, it is possible that in some future quarters the Company's operating results will fall below the expectations of the Company, market analysts and investors. In such event, the price of the Company's Common Stock would likely be materially and adversely affected.

Dependence on New Products; Rapid Technological Change; Product Development and Implementation Risks

The market for customer management software and related consulting and training services is subject to rapid technological change, changing customer needs and preferences, frequent new product introductions, and evolving programming languages and industry standards that may render existing products and services obsolete. The Company's position in its current market or other markets that it may enter could be eroded rapidly by product advances. The life cycles of the Company's products are difficult to estimate, and the Company's growth and future performance will depend in part upon its ability to enhance existing products, and to develop and introduce new products that keep pace with technological advancements, meet changing customer requirements, respond to competitive products, and achieve market acceptance. The Company's product development efforts require and are expected to continue to require substantial investments by the Company for research, refinement and testing, and there can be no assurance that the Company will have the resources sufficient to make such investments. The Company has in the past experienced developmental delays, and there can be no assurance that the Company will not experience difficulties which would delay or prevent the successful development, introduction or implementation of new or enhanced products. In addition, there can be no assurance that such products will meet the requirements of the marketplace and achieve market acceptance, or that the Company's current or future products will conform to changing industry requirements. If the Company is unable for technological or other reasons to develop, introduce or implement new or enhanced products in a timely and effective manner, the Company's business, operating results and financial condition could be materially and adversely affected.

Products as complex as the Company's may contain errors that may be detected at any point in the products' life cycles. In the past, the Company has discovered certain errors in its products and has experienced shipping delays while such errors were corrected. Such errors have also required the Company to ship corrected products to existing customers. There can be no assurance that errors will not be found in the future resulting in the loss of, or delay in, market acceptance and/or sales and revenue, diversion of development resources, injury to the Company's reputation, or increased service and warranty costs, any of which could have a material adverse effect on the Company's business, operating results and financial condition.

Computing Platform Shift; Compatibility with Third Party Relational Databases

The majority of large financial services organizations have traditionally used IBM MVS or Digital Equipment Corporation VMS systems for transaction processing. Increasingly, however, such organizations are migrating towards more open UNIX and Windows/NT server operating systems to meet their transaction processing requirements. Responding to this trend, and while continuing to support its core IBM and Digital Equipment Corporation platforms, the Company commenced efforts in 1992 to evolve versions of its products to use the C++ programming language and run on a variety of open platforms. In December 1995, for the first time one of the new C++ versions of the Company's products was used in production by a customer of the Company. The Company has since shipped new C++

versions of its products for use on RS 6000/AIX, Digital OpenVMS, Sun Solaris and Windows/NT platforms, of which the RS 6000/AIX, Digital OpenVMS and Sun Solaris systems have been brought into initial production use. The Company is actively working with customers to bring additional installations of these products into production. There can be no assurance that the new versions of the Company's products will meet the requirements of the marketplace and achieve market acceptance, or that organizations will not migrate to other computing platforms not supported by the Company. Moreover, there can be no assurance that, notwithstanding the benefits of the new versions of the Company's products, some of the Company's existing customers may choose not to migrate to UNIX and Windows/NT systems. In such event, the Company may be required to support both the old and new versions of its products, which could have a material adverse effect on its business, operating results and financial condition.

The Company believes that the compatibility of customer service management software systems with popular relational databases is an important factor in the purchase decision of many organizations. Consequently, the Company recently developed and shipped Sun Solaris and Windows/NT versions of its software capable of storing work items in Oracle and Microsoft SQL Server relational databases. However, the Company's existing and potential customers may demand that the Company's systems be compatible with other relational databases and there can be no assurance that the Company will not experience difficulties which would delay or prevent the successful development or introduction of these additional capabilities. Any such difficulty could have a material and adverse effect on the Company's business, operating results and financial condition.

Dependence on the Financial Services Market; Industry Consolidation

The Company has derived all of its revenue to date from customers in the financial services market, and the Company's future growth depends, in large part, upon increased sales to this market. The financial condition of the Company's customers and their willingness to pay for the Company's products and services are affected by competitive pressures, decreasing operating margins within the industry, currency fluctuations, active geographic expansion and deregulation. The Company believes that its customers' purchasing patterns are somewhat discretionary. As a result, demand for the Company's products and services could be affected by the condition of the financial services market or a deterioration in economic or market conditions generally.

The financial services market is undergoing intense domestic and international consolidation. In recent years, several customers of the Company have been merged or consolidated out of independent existence, and there is no assurance that the Company will not experience declines in revenue occasioned, in whole or in part, by future mergers or consolidations. Any decline in the demand for the Company's products would have a material, adverse effect on the Company's business, operating results and financial condition.

Uncertainty of Growth into other Markets

As part of its growth strategy the Company is exploring the possibility of applying its technology to the customer service management requirements of markets other than financial services, such as insurance, telecommunications, medical, public utilities and retail. The Company believes that in connection with such efforts it will be necessary for the Company to hire additional personnel with expertise in these other markets. There can be no assurance that the Company will be successful in adapting its technology to these other markets or in attracting and retaining personnel with the necessary industry expertise. The inability of the Company to penetrate these other markets could have a material adverse effect on its business, operating results and financial condition.

Risks of Customer License Non-Renewal

To date, a substantial majority of the Company's licenses have been renewed upon expiration. Revenue attributable to license renewals has historically accounted for a significant portion of the Company's total revenue. There can be no assurance that a substantial majority of the Company's customers will continue to renew expiring licenses; any such non-renewal would require the Company to obtain revenue from other sources in order to achieve its revenue targets. A decrease in the Company's license renewal rate without offsetting revenue from other sources would have a material adverse effect on the Company's business, results of operations and financial condition.

Dependence on Key Personnel

The Company's future success depends to a significant extent on Mr. Trefler, its other executive officers and certain technical, managerial, consulting, sales and marketing personnel. The loss of the services of any of these individuals or group of individuals could have a material adverse effect on the Company's business, operating results and financial condition. None of the Company's executive officers has entered into an employment contract with the Company, although each is subject to a non-disclosure and non-competition agreement with the Company. The Company does not have, and is not contemplating securing, any significant amount of key-man life insurance on any of its executive officers or other key employees. The Company believes that its future success also will depend significantly upon its ability to attract, motivate and retain additional highly skilled technical, managerial, consulting, sales and marketing personnel. In particular, delays in hiring and training qualified sales personnel would adversely affect the Company's operating results due to the substantial time period between the identification of new customers and the successful implementation and acceptance of the Company's products by those customers. Because developing, selling and maintaining the Company's products requires extensive knowledge of computer hardware and operating systems, programming languages and application software, the number of qualified potential employees is limited. Moreover, competition for such personnel is intense, and there can be no assurance that the Company will be successful in attracting and retaining the personnel it requires to continue to grow and operate profitably.

Intense Competition

The market for customer service management software and related consulting and training services is relatively new, intensely competitive and highly fragmented. The Company encounters significant competition from internal information systems departments of potential or existing customers that develop custom software. The Company also competes with companies that target the customer interaction or workflow markets, and professional services organizations that develop custom software in conjunction with rendering consulting services. Such competitors vary in size and in the scope and breadth of products and services offered. The Company anticipates increased competition for market share and pressure to reduce prices and make sales concessions, which could materially and adversely affect the Company's business, operating results and financial condition.

Many of the Company's competitors have greater resources than the Company, and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards, or to changes in customer requirements or preferences. Many of the Company's competitors can devote greater managerial or financial resources than the Company can to develop, promote and distribute customer service management software products and provide related consulting and training services. There can be no assurance that the Company's current or future competitors will not develop products or services which may be superior in one or more respects to the Company's or which may gain greater market acceptance. Some of the Company's competitors have established or may establish cooperative arrangements or strategic alliances among themselves or with third parties, thus enhancing their abilities to compete with the Company. It is likely that new competitors will emerge and rapidly acquire market share. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that the competitive pressures faced by the Company will not materially and adversely affect its business, operating results and financial condition.

Management of Growth

The growth in the size, geographic scope and complexity of the Company's business and the expansion of its product offerings and customer base have placed and are expected to continue to place a significant strain on the Company's management, operations and capital needs. The Company's continued growth, if any, will require it to hire, train and retain many employees both in the United States and abroad, particularly additional sales and financial personnel, and will also require the Company to enhance its financial and managerial controls and reporting systems. There is no assurance that the Company can manage its growth effectively or that the Company will be able to attract and retain the necessary personnel to meet its business challenges. If the Company is unable to manage its growth effectively, the Company's business, operating results and financial condition could be materially and adversely affected.

Risks Associated with International Operations; Currency and Other Risks

Sales to customers headquartered outside of the United States represented approximately 10.5% and 17.7% of the Company's total revenue in 1995 and 1996, respectively. The Company, in part through its wholly-owned subsidiary based in the United Kingdom, markets products and renders consulting and training services to customers based in Canada, the United Kingdom, France, Switzerland, Ireland, Luxembourg, Mexico and Sweden and is in negotiations with potential customers based in other foreign countries. The Company recently established an office in Paris, France, and may establish additional offices in continental Europe, Australia or elsewhere in the Pacific Rim. The Company believes that its continued growth will necessitate expanded international operations requiring a diversion of managerial attention and financial resources. The Company anticipates hiring additional personnel to accommodate international growth, and the Company may also enter into agreements with local distributors, representatives or resellers. If the Company is unable to do one or more of these things in a timely manner, the Company's growth, if any, in its foreign operations will be restricted, and the Company's business, operating results and financial condition could be materially and adversely affected.

In addition, there can be no assurance that the Company will be able to maintain or increase international market demand for its products. Most of the Company's international sales are denominated in U.S. dollars. Accordingly, any appreciation of the value of the U.S. dollar relative to the currencies of those countries in which the Company distributes its products may place the Company at a competitive disadvantage by effectively making its products more expensive as compared to those of its competitors.

Additional risks inherent in the Company's international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing products for local markets and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of "double taxation"), enhanced accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws. There can be no assurance that one or more of these factors will not have a material adverse effect on the Company's foreign operations, and, consequentially, the Company's business, operating results and financial condition.

Reliance on Certain Relationships

The Company has a number of third party relationships that are significant to its sales, marketing and support activities and product development efforts. The Company relies upon relational database management systems applications and development tool vendors, software and hardware vendors, and consultants to provide marketing and sales opportunities for the Company's direct sales force, and strengthen its product offerings through the use of industry-standard tools and utilities. The Company has also recently begun establishing relationships with third parties that will distribute the Company's products. The Company's strategy in entering into these relationships is to keep pace with the technological and marketing developments of major software vendors, to acquire technical assistance for the Company's product development efforts and to leverage the Company's sales and marketing capabilities. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources than the Company, will not develop or market software products which compete with the Company's products in the future or will not otherwise discontinue their relationships with or support of the Company. The failure of the Company to maintain its existing relationships, or to establish new relationships in the future, because of a divergence of interests, acquisition of one or more of these third parties, or for any other reason, could have a material adverse effect on the Company's business, results of operations and financial condition.

PART II

Item 5 MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Information relating to the market for the Company's Common Stock and related stockholder matters is contained on page 35 of the 1996 Annual Report in the section entitled "Stock Price History and Related Stockholder Matters," which section is incorporated herein by reference.

Item 6 FIVE YEAR COMPARISON OF SELECTED CONSOLIDATED FINANCIAL DATA

Selected consolidated financial data is contained on page 15 of the 1996 Annual Report in the section entitled "Five Year Comparison of Selected Consolidated Financial Data," which section is incorporated herein by reference.

Item 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information is contained on pages 16 to 21 of the 1996 Annual Report in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," which section is incorporated herein by reference.

Item 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Financial statements and supplementary data are contained on pages 22 to 34 of the 1996 Annual Report in the sections entitled "Consolidated Balance Sheets," "Consolidated Statements of Income," "Consolidated Statements of Stockholders' Equity," "Consolidated Statements of Cash Flows," "Notes to Consolidated Financial Statements" and "Report of Independent Auditors" which sections are incorporated herein by reference. Financial statement schedules are set forth in Item 14, "Exhibits, Financial Statement Schedules, and Reports on Form 8-K" of this Form 10-K and are filed herewith.

Item 9 CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

PART III

Item 10 DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information relating to the Directors of the Company is set forth in the section entitled "Management - Directors" in the 1997 Proxy Statement, which section is incorporated herein by reference. Information relating to the executive officers of the Company is set forth in Part I, immediately following Item 4, of this Report under the caption "Executive Officers of the Registrant." Information relating to compliance with Section 16(a) of the Securities Exchange Act of 1934 is set forth in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the 1997 Proxy Statement, which section is incorporated herein by reference.

Item 11 EXECUTIVE COMPENSATION

Information relating to executive compensation is set forth in the sections entitled "Management - Directors - Director Compensation," "Executive Compensation," "Option Grants," "Aggregated Option Exercises and Year-End Option Table," "Change in Control Arrangements," and "Compensation Committee Interlocks and Insider Participation" in the 1997 Proxy Statement, which sections are incorporated herein by reference.

Item 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information relating to ownership of equity securities of the Company by certain beneficial owners and management is set forth in the section entitled "Principal and Management Stockholders" in the 1997 Proxy Statement, which section is incorporated herein by reference.

Item 13 CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information relating to certain relationships and related transactions is set forth in the section entitled "Management - Certain Relationships and Related Transactions" in the 1997 Proxy Statement, which section is incorporated herein by reference.

PART IV

Item 14 EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) (1) Financial Statements of Pegasystems Inc.

The following consolidated financial statements required by Item 8 of this Form 10-K are incorporated by reference from the 1996 Annual Report.

Item	Location in 1996 Annual Report
Consolidated Balance Sheets at December 31, 1995 and 1996	Page 22
Consolidated Statements of Income for the years ended December 31, 1994, 1995 and 1996	Page 23
Consolidated Statements of Stockholders' Equity for the years ended December 31, 1994, 1995 and 1996	Page 24
Consolidated Statements of Cash Flows for the years ended December 31, 1994, 1995 and 1996	Page 25
Notes to Consolidated Financial Statements	Page 26 - 33
Report of Independent Auditors	Page 34

(2) Financial Statement Schedules of Pegasystems Inc.

The following financial statement schedule as of December 31, 1995 and 1996 and for the years ended December 31, 1994, 1995 and 1996 is required to be filed by Item 8 of this Form 10-K, and is filed herewith as noted below. The financial statement schedule should be read in conjunction with the consolidated financial statements of Pegasystems.

Schedule II - Valuation and Qualifying Accounts	Page 28

All other schedules are omitted because the required information is not present or not present in sufficient amounts to require submission of the schedule or because the information is reflected in the consolidated financial statements or notes thereto.

(3) Exhibits

The exhibits filed as part of this Report are listed in the Exhibit Index immediately following the financial statement schedule included in this Report.

(b) Reports on Form 8-K

The Registrant did not file any reports on Form 8-K during the fourth quarter of 1996.

SIGNATURES

Pursuant to the requirements to Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

PEGASYSTEMS INC.

Date: March 28, 1997

By: /s/ Ira Vishner
Ira Vishner, Vice President of Corporate Services, Treasurer, Chief Financial Officer and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below on March 28, 1997 by the following persons on behalf of the Registrant and in the capacities indicated.

/s/ Alan Trefler *Alan Trefler*	*President, Clerk and Director (principal executive officer)*
/s/ Ira Vishner *Ira Vishner*	*Vice President of Corporate Services, Treasurer, Chief Financial Officer and Director (principal financial and accounting officer)*
/s/ Edward A. Maybury *Edward A. Maybury*	*Director*
/s/ Edward B. Roberts *Edward B. Roberts*	*Director*
/s/ Leonard A. Schlesinger *Leonard A. Schlesinger*	*Director*
/s/ Thomas E. Swithenbank *Thomas E. Swithenbank*	*Director*

SCHEDULE II

PEGASYSTEMS INC. AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS
Three Years Ended December 31, 1996

Description	Balance at beg-inning of period	Additions charged to costs and expenses	Charged to other account (a)	Deductions (b)	Balance at end of period
Allowance for doubtful accounts:					
Year ended December 31, 1994	$340,041	$0	$0	$340,041	$0
Year ended December 31, 1995	0	793,310	0	359,423	433,887
Year ended December 31, 1996	433,887	300,000	204,685	0	938,572

(a) Amount reclassified from liabilities during the year.
(b) Deductions are related to accounts receivable write-offs.

PEGASYSTEMS INC.

Exhibit Index

Exhibit No.	Description
3.3.*	Restated Articles of Organization of the Registrant.
3.4.*	Restated By-Laws of the Registrant.
4.1.*	Specimen certificate representing the Common Stock.
10.1.*	Amended and Restated 1994 Long-Term Incentive Plan.
10.2.*	1996 Non-Employee Director Stock Option Plan.
10.3.*	1996 Employee Stock Purchase Plan.
10.4.*	Loan Agreement dated as of December 16, 1993 between the Registrant and Fleet Bank of Massachusetts, N.A.
10.5.*	Loan Modification Agreement dated as of May 5, 1995 between the Registrant and Fleet Bank of Massachusetts, N.A.
10.6.*	Second Loan Modification Agreement dated May 15, 1996 between the Registrant and Fleet National Bank (successor by merger to Fleet Bank of Massachusetts, N.A.).
10.11.*	Promissory Note dated May 15, 1996 in the amount of $5,000,000 made by the Registrant to the order of Fleet National Bank.
10.13.*	Lease Agreement dated February 26, 1993 between the Registrant and Riverside Office Park Joint Venture.
10.14.*	Amendment Number 1 to Lease Agreement dated August 7, 1994 between the Registrant and Riverside Office Park Joint Venture.
13.1	Portions of the 1996 Annual Report to Stockholders incorporated by reference into this Report.
21.1.*	Subsidiaries of the Registrant.
23.1.	Consent of Ernst & Young LLP.
27.1.	Financial Data Schedule.

*Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (Registration No. 333-03807) or an amendment thereto and incorporated herein

by reference to the same exhibit number.

Exhibit 13.1.

STOCK PRICE HISTORY AND RELATED STOCKHOLDER MATTERS (unaudited)

The following table sets forth the range of high and low sales prices on the National Association of Security Dealers Automatic Quotation ("Nasdaq") National Market System under the Nasdaq symbol PEGA, for 1996. The Company's common stock has been traded on the Nasdaq National Market System since its initial public offering in July 1996. Prior to that date, there was no public market for the Company's common stock. As of February 20, 1997, the Company had approximately 23 stockholders of record and approximately 2,300 beneficial owners of the Company's common stock. On February 20, 1997, the closing sale price of the common stock was $35.63. The Company has never declared or paid any dividends on its common stock. The Company intends to retain its earnings to finance future growth, and therefore does not anticipate paying any dividends in the foreseeable future.

1996	High	Low
Third Quarter (beginning July 19, 1996)	$27.00	$10.00
Fourth Quarter	$37.00	$26.13

PEGASYSTEMS INC.
FIVE YEAR COMPARISON OF SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data presented below at December 31, 1992, 1993, 1994, 1995 and 1996 have been derived from the consolidated financial statements of Pegasystems Inc. ("Pegasystems" or the "Company"). This data may not be indicative of the Company's future condition or results of operations and should be read in conjunction with the consolidated financial statements and related notes included herein.

	Years Ended December 31,				
	1992	1993	1994	1995	1996
Consolidated Statement of Income Data:	(in thousands, except per share data)				
Total revenue	$8,963	$10,212	$16,263	$22,247	$33,545
Income from operations	1,944	793	2,236	3,257	10,019
License interest income	1,220	1,305	1,457	1,486	1,565
Net income	1,867	1,233	2,193	2,878	7,500
Net income per share and common equivalent share	$0.08	$0.05	$0.09	$0.11	$0.28
Weighted average number of common and common equivalent shares outstanding	24,471	24,231	24,102	25,551	26,397
Dividends declared	--	--	--	--	--

	December 31,				
	1992	1993	1994	1995	1996
Consolidated Balance Sheet Data:	(in thousands)				
Cash and cash equivalents	$336	$435	$456	$511	$24,201
Working capital	3,428	4,231	4,441	4,393	34,364
Long-term license installments, net	6,319	6,782	9,135	13,399	23,802
Total assets	14,387	17,057	20,787	25,876	66,855
Long-term debt	118	458	450	816	--
Stockholders' equity	8,444	9,676	11,872	14,674	52,385

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company was founded in April 1983 to develop, market and support customer management software solutions for financial services organizations. Product development began immediately and by the end of the year the Company had secured its first customer. The Company has been profitable in each fiscal quarter since the first quarter of 1985.

The Company's revenue is derived from two sources: software license fees and services revenue. License fees, which have historically represented the majority of the Company's total revenue, are generally payable on a monthly basis under license agreements which typically have a five-year term and are subject to renewal at the customer's option for an additional fixed period. Such license agreements are generally non-cancellable, although some may be terminated by the licensee for a fee prior to the expiration of the initial term but after a minimum specified period. The Company's licenses generally provide for annual license fee increases (the "inflation adjustments") based on recognized inflation indexes (sometimes subject to maximums). The Company believes that both it and its customers derive substantial benefits from the recurring fee model because it encourages the Company to be responsive to customer needs and provides the Company with additional revenue opportunities through license renewals.

License revenue is generally recognized upon product acceptance. In the case of license renewals, revenue is recognized upon execution of the renewal agreement or if, as is generally the case, renewal is automatic unless the customer gives notice of termination, at the expiration of the period during which the customer has the right to terminate. The inflation adjustments are recognized ratably over the periods to which they apply. In accordance with Statement of Position No. 91-1 issued by the American Institute of Certified Public Accountants, the amount of software license revenue recognized upon product acceptance or license renewal is equal to the present value of the payments due during the minimum initial or renewal term, as the case may be, plus the present value of any early termination fee. In 1994, 1995 and the three months ended March 31, 1996, the discount rate for purposes of the present value calculation was 7%; for the nine months ended December 31, 1996, such discount rate was 6.75%. Commencing with the three months ended March 31, 1996, the Company has established and intends to continue to establish the discount rate quarterly as a function of the Company's then current marginal borrowing rate. The imputed interest portion of the license fees, which is reported as license interest income in the Company's consolidated statements of income, is recognized over the minimum initial or the renewal term, as the case may be. To date, a substantial majority of the Company's software licenses have been renewed upon expiration. The fact that a portion of the Company's revenue is derived from the renewal of license agreements with fixed expiration dates assists the Company in anticipating future revenue.

The Company's services revenue is comprised of fees for implementation, consulting, maintenance and training services. All software license customers are required to enter into a maintenance contract requiring the customer to pay a monthly maintenance fee over the term of the related license agreement equal to approximately 18% of the license fee. Maintenance fees are recognized ratably over the term of the maintenance agreement. The Company's software license agreements typically require the Company to provide a specified level of implementation services for a fixed fee, typically with additional implementation services available at an hourly rate. Implementation fees are payable upon the achievement of specified milestones. The Company generally recognizes implementation as well as consulting and training fees as the services are provided.

The Company's export revenue has fluctuated considerably in the past due to the fact that such revenue has been largely attributable to a small number of product acceptances during a given period. The Company's export revenue increased from $1.0 million in 1993 to $3.9 million in 1994 due primarily to product acceptance by a single customer in Ireland in 1994, the year in which the Company organized its subsidiary in the United Kingdom. Export revenue declined to $2.3 million in 1995 due to the lack of large product acceptances during the year. In 1996, export revenue increased to $5.9 million, as a result of new customers in the European marketplace.

Most of the Company's contracts are denominated in U.S. dollars, although several are denominated in other currencies, primarily British pounds sterling. The Company expects that in the future more of its contracts will be denominated in foreign currencies. The Company has not experienced any significant foreign exchange gains or losses, and the Company does not expect that foreign currency fluctuations will have a significant effect on either its revenue or costs in the near term.

The Company's business has experienced and is expected to continue to experience significant seasonality. In recent years the Company has recognized a greater percentage of its revenue in its third and fourth quarters than in its first and second quarters due to the Company's sales commission structure and the impact of that structure on the timing of product acceptances and license renewals by customers. This pattern is reinforced by the Company's maintenance contracts, which generally entitle customers to, among other things, a fixed number of hours of service per calendar year. Once the annual allotment of service hours is exhausted, customers pay for additional services on an hourly basis, typically resulting in higher services revenue in the Company's second, third, and fourth quarters.

RESULTS OF OPERATIONS

The following table sets forth for the years indicated the percentage of total revenue represented by certain items reflected in the Statements of Income of the Company:

	Years Ended December 31,		
	1994	1995	1996
	(as a percentage of total revenue)		
Revenue:			
Software license	59.4%	60.8%	66.4%
Services	40.6	39.2	33.6
Total revenue	100.0	100.0	100.0
Cost of revenue:			
Cost of software license	6.6	2.9	1.4
Cost of services	23.3	27.7	20.8
Total cost of revenue	29.9	30.6	22.2
Gross profit	70.1	69.4	77.8
Operating expenses:			
Research and development	33.5	31.7	24.5
Sales and marketing	16.2	16.1	17.9
General and administrative	6.7	6.9	5.5
Total operating expenses	56.4	54.7	47.9
Income from operations	13.7	14.7	29.9
License interest income	9.0	6.7	4.7
Other interest income	0.1	0.1	1.8
Interest expense	(0.3)	(0.5)	(0.3)
Income before provision for income taxes	22.5	21.0	36.1
Provision for income taxes	9.0	7.9	13.7
Net income	13.5%	13.1%	22.4%

YEAR ENDED DECEMBER 31, 1996 COMPARED TO YEAR ENDED DECEMBER 31, 1995

Revenue

Total revenue for 1996 increased 50.8% to $33.5 million from $22.2 million for 1995. The increase was primarily due to an increase in software license revenue.

Software license revenue for 1996 increased 64.5% to $22.3 million from $13.5 million in 1995. The increase in software license revenue was primarily attributable to software license acceptances by new customers, software license agreement renewals, expanded software usage by existing customers, the licensing of standard product templates, and inflation-based increases in monthly license fees.

Services revenue for 1996 increased 29.5% to $11.3 million from $8.7 million for 1995. The increase in services revenue was primarily attributable to increased demand for consulting and implementation services, and to a lesser extent, increased maintenance revenue from a larger installed product base.

Cost of Revenue

Cost of software license consists of amortization expense related to capitalized software development costs, royalty payments to third party software vendors, and costs of product media, duplication and packaging. Cost of software license for 1996 decreased 24.9% to $0.5 million from $0.6 million for 1995, and decreased as a percentage of total revenue from 2.9% for 1995 to 1.4% for 1996. As a percentage of software license revenue, cost of software license decreased from 4.7% for 1995 to 2.1% for 1996. Such decreases were due to decreased amortization expense related to capitalized software development costs. No software development costs were capitalized in 1995 or 1996.

Cost of services consists primarily of the costs of providing implementation, consulting, maintenance, and training services. Cost of services for 1996 increased 13.2% to $7.0 million from $6.2 million for 1995, mainly due to increased staffing in the Company's Reengineering and Client Services group in the United Kingdom and in the Company's domestic regional offices to meet growing client commitments. Cost of services as a percentage of total revenue declined from 27.7% for 1995 to 20.8% for 1996, and declined as a percentage of services revenue from 70.7% for 1995 to 61.8% for 1996, in both cases due to the growth in the Company's total revenue and increased utilization of service personnel.

Operating Expenses

Research and development expenses consist primarily of the cost of personnel and equipment needed to conduct the Company's research and development efforts. Research and development expenses for 1996 increased 16.4% to $8.2 million from $7.1 million for 1995. The increase in research and development expenses was due to the hiring of additional development personnel. As a percentage of total revenue, research and development expenses declined from 31.7% for 1995 to 24.5% for 1996, reflecting the Company's strategy of leveraging existing product functionality by balancing its historical focus on research and development with an increased emphasis on sales and marketing. In addition, research and development expenses declined as a percentage of total revenue due to the growth in the Company's total revenue.

Sales and marketing expenses for 1996 increased 67.0% to $6.0 million from $3.6 million for 1995. As a percentage of total revenue, sales and marketing expenses increased from 16.1% for 1995 to 17.9% for 1996. Such increases were attributable to the hiring of additional direct sales and marketing personnel, increased sales commission payments attributable to higher sales, and increased investment in marketing support activities and materials.

General and administrative expenses consist primarily of the salaries of the Company's executive, administrative and financial personnel, and associated expenses. General and administrative expenses for 1996 increased 20.5% to $1.9 million from $1.5 million for 1995 due to increased investment in the infrastructure needed to support the Company's growth. Such expenses declined as a percentage of total revenue from 6.9% for 1995 to 5.5% for 1996 due to the growth in the Company's total revenue.

License Interest Income

License interest income represents the portion of all license fees due under software license agreements which was not recognized upon product acceptance or license renewal. License interest income for 1996 increased 5.3% to $1.6 million from $1.5 million for 1995 reflecting a larger installed product base.

Provision for Income Taxes

The provisions for federal, state and foreign taxes were $1.8 million and $4.6 million for 1995 and 1996, respectively. The effective tax rates were 38.0% for 1995 and 38.1% for 1996. At December 31, 1996, the Company had $0.8 million in research and development tax credit carryforwards available to offset future federal taxable income. See Note 7 of Notes to Consolidated Financial Statements.

YEAR ENDED DECEMBER 31, 1995 COMPARED TO YEAR ENDED DECEMBER 31, 1994

Revenue

Total revenue for 1995 increased 36.8% to $22.2 million from $16.3 million for 1994 due primarily to an increase in software license revenue, and to a lesser extent, an increase in services revenue.

Software license revenue for 1995 increased 40.0% to $13.5 million from $9.7 million in 1994 due to increased product acceptances and license renewals.

Services revenue for 1995 increased 32.1% to $8.7 million from $6.6 million in 1994 primarily due to an increase in the amount of implementation and consulting services provided, and to a lesser extent, increases in the billing rates of the personnel providing these services and an increase in training revenue.

Cost of Revenue

Cost of software license for 1995 decreased 40.9% to $0.6 million from $1.1 million for 1994, and decreased as a percentage of total revenue from 6.6% for 1994 to 2.9% for 1995. As a percentage of software license revenue, cost of software license decreased from 11.1% for 1994 to 4.7% for 1995. Such decreases were due to reduced amortization of capitalized software development costs.

Cost of services for 1995 increased 62.5% to $6.2 million from $3.8 million for 1994 and increased as a percentage of total revenue from 23.3% for 1994 to 27.7% for 1995. Cost of services as a percentage of total services revenue increased from 57.4% for 1994 to 70.7% for 1995. Such increases were due to the hiring of additional personnel to provide implementation and consulting services to support the Company's growing customer base.

Operating Expenses

Research and development expenses for 1995 increased 29.8% to $7.1 million from $5.4 million for 1994 as a result of increased efforts by the Company to develop versions of its products capable of running on multiple UNIX platforms in a client/server environment. As a percentage of total revenue, research and development expenses declined from 33.5% for 1994 to 31.7% for 1995 due to the growth in the Company's total revenue.

Sales and marketing expenses for 1995 increased 36.6% to $3.6 million from $2.6 million for 1994 due to the hiring of additional sales and marketing personnel, increased sales commission payments and increased investment in trade shows and other sales and marketing efforts. As a percentage of total revenue, sales and marketing expenses decreased slightly from 16.2% for 1994 to 16.1% for 1995 due to growth in the Company's total revenue.

General and administrative expenses for 1995 increased 41.2% to $1.5 million from $1.1 million for 1994 due to increased management recruiting costs, the establishment of two new regional offices in Chicago and Dallas/Fort Worth and the relocation of the Company's United Kingdom office. General and administrative expenses were 6.7% in 1994 and 6.9% of total revenue in 1995.

License Interest Income

License interest income for 1995 and 1994 remained constant at $1.5 million.

Provision for Income Taxes

The provisions for federal, state and foreign taxes were $1.5 million and $1.8 million for 1994 and 1995, respectively. The effective tax rates were 40.0% for 1994 and 38.0% for 1995. The decrease in the effective tax rate was primarily due to increased availability of research and development tax credits. See Note 7 of Notes to Consolidated Financial Statements.

YEAR ENDED DECEMBER 31, 1994 COMPARED TO YEAR ENDED DECEMBER 31, 1993

Revenue

Total revenue for 1994 increased 59.2% to $16.3 million from $10.2 million for 1993. In January 1994, the Company organized Pegasystems Limited, a wholly-owned subsidiary based in the United Kingdom. In its first year of operation, Pegasystems Limited introduced the Company's products into Ireland, France and Luxembourg. Financial results for 1994 and subsequent years reflect the consolidated earnings of Pegasystems Inc. and Pegasystems Limited.

Software license revenue represented 59.4% and 63.1% of total revenue for 1994 and 1993, respectively. Software license revenue for 1994 increased 49.8% to $9.7 million from $6.4 million for 1993. The increase in software license revenue in 1994 was primarily attributable to increased product acceptances by customers headquartered outside of the United States. The Company's software license revenue from customers headquartered outside of the United States was $3.1 million, or 32.5% of software license revenue, and $0.7 million, or 10.8% of software license revenue, in 1994 and 1993, respectively.

Services revenue for 1994 increased 75.3% to $6.6 million from $3.8 million for 1993 primarily due to the increased amount of implementation and consulting services provided to a widening customer base. Following a focused internal reengineering effort which began in 1993 and continued into 1994, the Company redeveloped its strategy for new customer implementations leading to greater services revenue from more effective and timely implementations and the creation of standard training courses.

Cost of Revenue

Cost of software license decreased 13.5% to $1.1 million for 1994 from $1.2 million for 1993 and decreased as a percentage of total revenue from 12.2% for 1993 to 6.6% for 1994. As a percentage of software license revenue, cost of software license decreased from 19.3% for 1993 to 11.1% for 1994. Such decreases were due to reduced amortization of capitalized software development costs.

Cost of services for 1994 increased 70.3% to $3.8 million from $2.2 million for 1993 and increased as a percentage of total revenue from 21.8% for 1993 to 23.3% for 1994. Such increases were due to the costs associated with establishing the Company's United Kingdom office in January 1994 and with developing new training facilities in Cambridge, Massachusetts and San Francisco, California. Cost of services as a percentage of total services revenue decreased from 59.2% for 1993 to 57.4% for 1994 due to increased utilization of service personnel.

Operating Expenses

Research and development expenses for 1994 increased 44.4% to $5.4 million from $3.8 million for 1993 primarily as a result of efforts by the Company to develop versions of its products capable of running on multiple UNIX platforms in a client/server environment. As a percentage of total revenue, research and development expenses declined to 33.5% for 1994 from 36.9% for 1993 due to growth in the Company's total revenue.

Sales and marketing expenses for 1994 increased 94.7% to $2.6 million from $1.4 million for 1993, representing 16.2% and 13.2% of total revenue in the respective years. Such increases reflected the establishment of a sales operation in the United Kingdom and increased sales commission payments.

General and administrative expenses for 1994 increased 30.8% to $1.1 million from $0.8 million for 1993 due to overhead associated with the expansion of the Company's headquarters in Cambridge, Massachusetts, relocation of the regional office in San Francisco, California, and the establishment of operations in the United Kingdom. General and administrative expenses as a percentage of total revenue declined slightly to 6.7% for 1994 from 8.2% for 1993 due to the growth in the Company's total revenue.

License Interest Income

License interest income for 1994 increased 11.6% to $1.5 million from $1.3 million in 1993 primarily due to the prepayment by one customer in 1994 of certain monthly software license fees.

Provision for Income Taxes

The provisions for federal, state and foreign taxes were $0.9 million and $1.5 million for 1993 and 1994, respectively. The effective tax rates were 41.1% for 1993 and 40.0% for 1994. The decrease in the effective tax rate was primarily due to the use of certain tax credits. See Note 7 of Notes to Consolidated Financial Statements.

LIQUIDITY AND CAPITAL RESOURCES

Since its inception, the Company has funded its operations primarily through cash flow from operations and bank borrowings. In July 1996, the Company issued and sold 2.7 million shares of Common Stock in connection with its initial public offering. Net proceeds to the Company from such offering were approximately $29.4 million. At December 31, 1996, the Company had cash and cash equivalents of approximately $24.2 million and working capital of approximately $34.4 million. The Company's approach of charging license fees payable in installments over the term of its licenses has historically deferred the receipt of cash and, prior to its initial public offering, limited the availability of working capital.

Net cash provided by operating activities for the years ended December 31, 1994 and 1995 was $1.5 million and $0.8 million, respectively. Net cash used by operating activities for the year ended December 31, 1996 was $2.9 million. Such amounts were used to support the Company's working capital requirements.

The Company used $1.1 million, $1.4 million and $2.0 million of net cash during 1994, 1995 and 1996, respectively, to purchase property and equipment, primarily computer hardware and software, to support the Company's growing employee base and new regional office and training facilities. The Company's capital commitments consist primarily of operating leases for office space. At December 31, 1996, the Company's commitments under non-cancellable operating leases for office space with terms in excess of one year totaled $1.2 million, $1.1 million and $0.6 million for 1997, 1998 and 1999, respectively. The Company's total payments under such leases was $0.9 million, $1.1 million and $1.4 million for 1994, 1995 and 1996, respectively. See Note 6 of Notes to Consolidated Financial Statements.

The Company has a $5.0 million revolving credit line, which is unsecured and expires on June 30, 1997. At December 31, 1996, the Company had no borrowings under its revolving credit line. The Company's credit agreement prohibits the payment of dividends, has profitability requirements and requires maintenance of specified levels of tangible net worth and certain financial ratios. See Note 4 of Notes to Consolidated Financial Statements.

The Company recorded no bad debt expense in 1994. The Company recorded bad debt expense in the amounts of $0.8 million and $0.3 million in 1995 and 1996, respectively, as a result of indications that certain receivables relating primarily to services rendered by the Company would not be collected in full. The receivables with respect to which bad debt expense was recorded related primarily to maintenance and installation services provided by the Company. At the time such services were rendered (and the resulting revenue was recognized) there was no significant uncertainty regarding the acceptance thereof and the collectibility of the related receivables was probable.

The Company believes that the net proceeds from its initial public offering and its public offering which was completed in January 1997 together with cash generated by operations and availability under its bank credit facility will be sufficient to fund the Company's operations for at least the next year. However, there can be no assurance that additional capital beyond the amounts currently forecasted by the Company will not be required or that any such required additional capital will be available on reasonable terms, if at all, at such time as required by the Company.

INFLATION

Inflation has not had a significant impact on the Company's operating results to date, nor does the Company expect it to have a significant impact in the future due to the fact that the Company's license and maintenance fees are typically subject to annual increases based on recognized inflation indexes.

SIGNIFICANT CUSTOMERS

During 1994 one customer accounted for 16.8% of the Company's consolidated revenue. This customer also accounted for 12.6% of the Company's 1995 consolidated revenue. In 1995 two other customers accounted for 16.2% and 14.9%, respectively, of the Company's consolidated revenue. In 1996, the Company had three customers that accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Annual Report are "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. These statements involve various risks and uncertainties which could cause the Company's actual results to differ from those expressed in such forward-looking statements. These risks and uncertainties include the seasonal variation of the Company's operations and fluctuations in the Company's quarterly results, rapid technological change involving the Company's products, delays in product development and implementation, the technological compatibility of the Company's products with its customers' systems, the Company's dependence on customers in the financial services market, intense competition in the markets for the Company's products, risk of non-renewal by current customers, management of the Company's growth, and other risks and uncertainties. Works such as "expects," "anticipates," "intends," "plans," "believes," "estimates," and "should" and similar words and expressions are intended to identify the forward-looking statements contained in this Annual Report. These statements are based on estimates, projections, beliefs, and assumptions of the Company and its management and are not guarantees of future performance. Further information regarding those factors which could cause the Company's actual results to differ materially from any forward-looking statements contained herein is included in the Company's filings with the Securities and Exchange Commission.

PEGASYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share-related data)

Assets	December 31, 1995	December 31, 1996
Current assets:		
Cash and cash equivalents	$511	$24,201
Trade and installment accounts receivable, net of allowance for doubtful accounts of $434 and $939 at December 31, 1995 and 1996, respectively	8,896	14,582
Prepaid expenses and other assets	425	1,235
Total current assets	9,832	40,018
Long-term license installments, net	13,399	23,802
Equipment and improvements, net	2,172	3,035
Software development costs, net	473	--
Total assets	$25,876	$66,855
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$1,747	$2,697
Deferred revenue	114	53
Current portion of long-term debt	782	--
Deferred income taxes	2,796	2,904
Total current liabilities	5,439	5,654
Deferred income taxes	4,947	8,816
Long-term debt	816	--
Stockholders' equity:		
Preferred stock, $.01 par value, 1,000,000 shares authorized; no shares issued and outstanding	--	--
Common stock, $.01 par value, 45,000,000 shares authorized; 23,490,000 shares and 26,392,200 shares issued and outstanding at December 31, 1995 and December 31, 1996, respectively	235	264
Additional paid-in capital	106	30,206
Deferred compensation	(91)	(73)
Retained earnings	14,522	22,022
Cumulative foreign currency translation adjustment	(98)	(34)
	14,674	52,385
Total liabilities and stockholders' equity	$25,876	$66,855

The accompanying Notes are an integral part of these Consolidated Financial Statements.

PEGASYSTEMS INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)

	Years Ended December 31,		
	1994	1995	1996
Revenue			
Software license	$9,662	$13,528	$22,258
Services	6,601	8,719	11,287
Total revenue	16,263	22,247	33,545
Cost of revenue			
Cost of software license	1,075	635	477
Cost of services	3,791	6,161	6,975
Total cost of revenue	4,866	6,796	7,452
Gross profit	11,397	15,451	26,093
Operating expenses			
Research and development	5,440	7,061	8,218
Sales and marketing	2,629	3,592	5,999
General and administrative	1,092	1,541	1,857
Total operating expenses	9,161	12,194	16,074
Income from operations	2,236	3,257	10,019
License interest income	1,457	1,486	1,565
Other interest income	21	16	619
Interest expense	(56)	(118)	(85)
Income before provision for income taxes	3,658	4,641	12,118
Provision for income taxes	1,465	1,763	4,618
Net income	$2,193	$2,878	$7,500
Net income per common and common equivalent share	$0.09	$0.11	$0.28
Weighted average number of common and common equivalent shares outstanding	24,102	25,551	26,397

The accompanying Notes are an integral part of these Consolidated Financial Statements.

PEGASYSTEMS INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock						
	Number of Shares	Amount	Additional Paid-in Capital	Deferred Compensation	Retained Earnings	Cumulative Foreign Currency Translation Adjustment	Total Stockholders' Equity
Balance at December 31, 1993	22,617	$226	--	--	$9,451	--	$9,677
Exercise of stock options	873	9	$15	--	--	--	24
Foreign currency translation adjustment	--	--	--	--	--	$(22)	(22)
Net income	--	--	--	--	2,193	--	2,193
Balance at December 31, 1994	23,490	235	15	--	11,644	(22)	11,872
Foreign currency translation adjustment	--	--	--	--	--	(76)	(76)
Issuance of stock options	--	--	91	$(91)	--	--	--
Net income	--	--	--	--	2,878	--	2,878
Balance at December 31, 1995	23,490	235	106	(91)	14,522	(98)	14,674
Issuance of common stock	2,700	27	29,339	--	--	--	29,366
Exercise of stock options	202	2	64	--	--	--	66
Tax benefit from exercise of stock options	--	--	697	--	--	--	697
Foreign currency translation adjustment	--	--	--	--	--	64	64
Amortization of deferred compensation	--	--	--	18	--	--	18
Net income	--	--	--	--	7,500	--	7,500
Balance at December 31, 1996	26,392	$264	$30,206	$(73)	$22,022	$(34)	$52,385

The accompanying Notes are an integral part of these Consolidated Financial Statements.

PEGASYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	1994	1995	1996
Operating activities			
Net income	$2,193	$2,878	$7,500
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Provision for deferred income taxes	961	1,836	3,977
Depreciation and amortization	1,511	1,455	1,633
Provision for doubtful accounts	--	793	300
Change in operating assets and liabilities:			
Increase in trade and installment accounts receivable	(3,988)	(5,638)	(16,389)
Increase in prepaid expenses and other assets	(16)	(221)	(810)
Decrease in inventory	215	--	--
Increase (decrease) in accounts payable and accrued expenses	971	(244)	950
Decrease in deferred revenue	(336)	(25)	(61)
Net cash provided (used) by operating activities	1,511	834	(2,900)
Investing activities			
Purchase of equipment and improvements	(1,131)	(1,423)	(2,005)
Software development costs	(297)	--	--
Net cash used in investing activities	(1,428)	(1,423)	(2,005)
Financing activities			
Repayment of note payable to shareholder	(180)	(50)	--
Proceeds from issuance of long-term debt	380	1,345	--
Repayments of long-term debt	(263)	(575)	(1,598)
Issuance of common stock, net	--	--	29,366
Exercise of stock options	23	--	66
Tax benefit from exercise of stock options	--	--	697
Net cash provided (used) by financing activities	(40)	720	28,531
Effect of exchange rate on cash	(22)	(76)	64
Net increase in cash	21	55	23,690
Cash and cash equivalents at beginning of year	435	456	511
Cash and cash equivalents at end of year	$456	$511	$24,201
Supplemental Disclosures of Cash Flow Information:			
Cash paid during period:			
Interest	$56	$119	$86
Income taxes	$135	$315	$90

The accompanying Notes are an integral part of these Consolidated Financial Statements.

PEGASYSTEMS INC.- NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - December 31, 1996

1. SIGNIFICANT ACCOUNTING POLICIES

Business
Pegasystems Inc. (the Company) was incorporated on April 21, 1983, and develops customer service management software used by large, transaction-intensive organizations to automate and manage their customer interactions. Customers of the Company include large banks and credit card processors and mutual fund companies. The Company also offers consulting, training, and maintenance and support services to facilitate the installation and use of its solutions.

The environment of rapid technological change and intense competition which is characteristic of the software development industry results in frequent new products and evolving industry standards. The Company's continued success depends upon its ability to enhance current products and develop new products on a timely basis which keep pace with the changes in technology and competitors' innovations.

International revenue is subject to various risks including imposition of government controls, export license requirements, political and economic conditions and instability, trade restrictions, currency fluctuations, changes in taxes, difficulties in staffing and managing international operations, and high local wage scales and other operating costs and expenses.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Pegasystems Limited and Pegasystems Investment Inc. All intercompany accounts and transactions have been eliminated in consolidation.

Foreign Currency Translation

The translation of assets and liabilities of the Company's foreign subsidiary is made at year-end rates of exchange, while revenue and expense accounts are recorded at the average rates of exchange. The resulting translation adjustments are excluded from net income and are charged or credited to "Cumulative foreign currency translation adjustment" included as part of stockholders' equity. Realized and unrealized exchange gains or losses from transaction adjustments are reflected in operations and are not material.

Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position 91-1, "Software Revenue Recognition," issued by the American Institute of Certified Public Accountants. Specifically, revenue from software licenses is generally recognized upon product acceptance pursuant to non-cancellable license agreements, and is based on management's assessment that the collectibility risk on the long-term license installments is low. Upon acceptance, the Company has no significant vendor obligations. The Company accrues the estimated cost of warranty and product returns in the period in which product revenue is recognized; historically these amounts have not been material. In the case of license renewals, revenue is recognized upon execution of the renewal license agreement or if, as is generally the case, renewal is automatic unless the customer gives notice of termination, at the expiration of the period during which the customer has the right to terminate. Maintenance fees are recognized ratably over the term of the maintenance agreement. The Company recognizes implementation as well as consulting and training fees as the services are provided.

Software license revenue represents the present value of future payments under non-cancellable license agreements which provide for payment in installments typically over a five-year period. A portion of the revenue from each agreement is recognized as interest income over the term of the agreement.

The discount rate in effect for 1994, 1995 and the three months ended March 31, 1996 was 7%. The discount rate for the nine month period ended December 31, 1996 was 6.75%. The trade and installment accounts receivable recorded on the balance sheet are net of $3.9 million and $5.1 million as of December 31, 1995 and 1996, respectively, which represents the imputed interest portion of future payments due under the Company's license agreements. Deferred revenue represents payments from customers, primarily for maintenance services, which are recognized as revenue as the related services are performed.

Cash and Cash Equivalents

Cash and cash equivalents are stated at cost, which approximates market, and consist of short-term, highly liquid investments with original maturities of less than three months.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of substantially all of the trade accounts receivable and long-term license installments receivable. The Company records long-term license installments in accordance with its revenue recognition policy which results in receivables from customers, primarily large financial service organizations with strong credit ratings.

Equipment and Improvements

Equipment and improvements are recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets which are three years for equipment and five years for furniture and fixtures. Leasehold improvements are amortized over the life of the lease.

Software Development Costs

In compliance with Statement of Financial Accounting Standards (SFAS) No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed," certain software development costs are capitalized in the accompanying consolidated balance sheets. Capitalization of software development costs begins upon the establishment of technological feasibility, defined by the Company as a working model or an operative version of the computer software product that is completed in the same language and is capable of running on all of the platforms as the product to be ultimately marketed. During 1994, the Company capitalized $0.3 million of software costs. No costs were capitalized during 1995 or 1996.

Amortization of capitalized software development cost is included in costs of software license revenue and is provided on a straight-line basis of two years, which approximates the estimated useful life of the software as it relates to the Company's sales. The straight-line amortization is not materially different from the amortization computed using the current period revenues as a percent of total expected product revenues. Total amortization expense charged to operations was $1.1 million, $0.6 million and $0.5 million during 1994, 1995 and 1996, respectively.

Net Income Per Share

Net income per common and common equivalent share is computed using the weighted average number of common and common equivalent shares outstanding during each period, assuming the exercise of stock options into common stock under the treasury stock method. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive; however, pursuant to the requirements of the Securities and Exchange Commission, common stock equivalent shares relating to stock options (using the treasury stock method and the initial public offering price) issued during the twelve months prior to the registration statement filed with respect to the initial filing of the initial public offering are included for all periods presented whether or not they are anti-dilutive. Fully-diluted earnings per common share are not presented as they are not materially different from primary earnings per common share. Dilutive common equivalent shares consist of stock options (using the treasury stock method and using the assumed initial public offering price). Net income per share also reflects a fifteen-for-one stock split effective December 9, 1994, and a three-for-one stock split effective July 10, 1996.

Stock Options

The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair market value of the shares at the date of the grant. The Company accounts for stock option grants in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and intends to continue to do so. During 1995, the Company granted stock options for a fixed number of shares to employees with an exercise price less than the then fair market value of the shares at the date of the grant. For the difference between the fair market value and the exercise price, the Company recorded deferred compensation which is being expensed over the vesting period.

The Company has adopted the disclosure provisions only of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("FAS 123") and will continue to account for its stock option plans in accordance with the provisions of APB 25, "Accounting for Stock Issued to Employees."

Use of Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Some of the areas where estimates are utilized included allowance for bad debts, capitalized software, income taxes, revenue and various accrued expenses. Actual results could differ from those estimates.

2. EQUIPMENT AND IMPROVEMENTS

The cost and accumulated depreciation of equipment and improvements consist of the following:

	December 31, (in thousands)	
	1995	1996
Equipment	$2,186	$3,956
Furniture and fixtures	863	1,005
Leasehold improvements	434	527
	3,483	5,488
Less accumulated depreciation	(1,311)	(2,453)
Equipment and improvements, net	$2,172	$3,035

Depreciation expense was approximately $0.4 million, $0.8 million and $1.2 million for the years ended December 31, 1994, 1995 and 1996, respectively.

3. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following:

	December 31, (in thousands) 1995	1996
Trade accounts payable	$557	$692
Employee compensation and benefits	568	1,257
Accrued income taxes	--	160
Other	622	588
	$1,747	$2,697

4. DEBT AND OTHER FINANCIAL INSTRUMENTS

Long-term debt consists of the following:

	December 31, (in thousands) 1995	1996
Note payable to bank, with originally scheduled monthly payments of $17 thousand plus interest through December 1, 1996	$207	--
Note payable to bank, with originally scheduled monthly payments of $11 thousand plus interest through December 1, 1997	243	--
Note payable to bank, with originally scheduled monthly payments of $33 thousand plus interest through June 28, 1998	983	--
Note payable to bank, with originally scheduled monthly payments of $5 thousand plus interest through December 28, 1998	165	--
	1,598	--
Less current portion	(782)	--
	$816	--

The notes bore interest at the bank's prime rate (8.5% at December 31, 1995) plus 1/2%. The notes were secured by all computer equipment and furniture and fixtures of the Company. As of December 31, 1996, the Company had repaid all of the notes.

As of December 31, 1995, the Company had a line of credit with a bank allowing for borrowings up to $2.5 million at the prime rate, which line of credit was scheduled to expire on June 1, 1996. As of December 31, 1996, the Company's bank line of credit had been increased to $5.0 million and extended until June 30, 1997. The Company had no drawings against the line of credit at December 31, 1995 and 1996. Borrowings are subject to various covenants which call for a specified level of working capital and net worth, maintenance of certain financial ratios, and restrictions on the payments of dividends.

Financial instruments outstanding at December 31, 1995 and 1996 are as follows:

	December 31, (in thousands)		December 31, (in thousands)	
	1995	1995	1996	1996
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and cash equivalents	$511	$511	$24,201	$24,201
Liabilities:				
Notes payable to a bank	(1,598)	(1,598)	--	--

5. EMPLOYEE BENEFIT PLANS

Stock Option Plan

The Company adopted an incentive stock option plan effective July 29, 1983 (the "1983 Plan"). Key employees, as selected by the Board of Directors of the Company, were granted options to purchase the Company's common stock at a price, which in the Board of Directors' opinion, reflected fair value on the date of the grant. The 1983 plan expired in 1993. At December 31, 1996, no options issued under this plan were outstanding.

Long-Term Incentive Plan

During the year ended December 31, 1994, the Company adopted a Long-Term Incentive Plan (the "1994 Plan") to provide incentives to employees, directors and consultants through opportunities to purchase stock through incentive stock options and through options which do not qualify as incentive stock options.

In addition to options, eligible participants under the 1994 Plan may be granted stock appreciation rights, restricted stock and long-term performance awards. At December 31, 1995, 2.4 million shares were reserved for issuance under the 1994 Plan. As of December 31, 1996, the Company had approved an increase in the number of shares issuable under the 1994 Plan from 2.4 million to 5.0 million. Shares equal to 2% of the outstanding shares at the start of each fiscal year shall be reserved for granting of replacement options; however, this may not cause the maximum shareholder dilution caused by the 1994 Plan to exceed the 5.0 million shares of stock reserved for issuance under the 1994 Plan.

The option price per share is to be determined at the date of grant. For incentive stock options, the option price may not be less than 100% of the fair market value of the Company's common stock at the grant date. Incentive stock options granted to a person having greater than 10% of the voting power of all classes of stock must have an exercise price of at least 110% of fair market value of the Company's common stock.

1996 Non-Employee Director Stock Option Plan

The 1996 Non-Employee Director Stock Option Plan (the "Director Plan") was adopted by the Board of Directors on May 13, 1996 and approved by the stockholders on June 26, 1996. The Director Plan provides for the grant of options for the purchase of up to 250,000 shares of Common Stock of the Company. As of December 31, 1996, options to purchase 90,000 shares were outstanding under the Director Plan.

The Director Plan is administered by the Compensation Committee and provides that each person who becomes a director of the Company after May 13, 1996, and who is not also an employee of the Company, will receive upon initial election to the Board of Directors an option to purchase 30,000 shares of Common Stock vesting in equal annual installments over five years. The exercise price for all options granted under the Director Plan is equal to the market price of the Common Stock as of the date of grant.

1996 Employee Stock Purchase Plan

The 1996 Employee Stock Purchase Plan (the "Stock Purchase Plan") was adopted by the Board of Directors on May 13, 1996 and approved by the stockholders on June 26, 1996. An aggregate of 500,000 shares of Common Stock are reserved for issuance pursuant to this plan. To date, there have been no offerings under the Stock Purchase Plan and no shares of Common Stock have been issued thereunder.

The following table presents the combined activity of the two option plans in which offerings have occurred for the years ended December 31, 1994, 1995 and 1996:

	1994		1995		1996	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
	(in thousands)		(in thousands)		(in thousands)	
Outstanding options at beginning of year	1,269	$0.23	1,672	$0.33	1,924	$0.34
Granted	1,636	$0.33	335	$0.39	993	$13.19
Exercised	(873)	$0.03	--	--	(202)	$0.33
Cancelled	(360)	$0.66	(83)	$0.48	(133)	$4.94
Outstanding options at end of year	1,672	$0.33	1,924	$0.34	2,582	$5.04
Exercisable options at end of year	396	$0.36	606	$0.33	679	$0.33
Weighted average fair value of options granted during the year	$0.10		$0.09		$8.84	

In December 1995, the Company granted options to purchase 335,250 shares of Common Stock at an exercise price of $.39 per share. The Company recorded an increase to additional paid-in capital and a corresponding charge to deferred compensation in the amount of $91,000 to recognize the aggregate difference between the deemed fair value for accounting purposes of the stock options at the date of grant and the exercise price. The deferred compensation will be amortized over the option vesting period of five years.

The following table presents weighted average price and life information about significant option groups outstanding at December 31, 1996:

Range of exercise prices	Options Outstanding: Number Outstanding (in thousands)	Options Outstanding: Weighted Average Remaining Contractual Life (years)	Options Outstanding: Weighted Average Exercise Price	Options Exercisable: Number Exercisable (in thousands)	Options Exercisable: Weighted Average Exercise
$0.33 - $0.39	1,620	8.2	$0.34	679	$0.33
$6.00 - $10.00	698	9.4	$9.60	--	--
$12.50 - $26.50	158	9.6	$16.52	--	--
$29.00 - $30.50	106	9.9	$29.86	--	--
	2,582			679	

Pursuant to the requirements of FAS 123, the following are the pro forma net income and net income per share for 1995 and 1996, as if the compensation expense for the option plans had been determined based on the fair value at the grant date for grants in 1995 and 1996, consistent with the provisions of FAS 123:

	1995 As Reported	1995 Pro Forma	1996 As Reported	1996 Pro Forma
Net income (in thousands)	$2,878	$2,878	$7,500	$7,122
Net income per share	$0.11	$0.11	$0.28	$0.27

A range of expected vesting percentages were given to each range of exercise prices. For the range of exercise prices from $0.33 to $0.39, $6.00 to $10.00, $12.50 to $26.50 and $29.00 to $30.50, it is expected that 95 percent, 90 percent, 75 percent and 50 percent of those options will vest, respectively. These ranges were based upon the Company's estimates that a more significant number of lower priced options as compared to higher priced options will vest.

The fair value of options at the date of grant were estimated using the Black-Scholes model with the following weighted-average assumptions:

	Option 1995	Option 1996
Volatility	0.0	0.0 - 9.9
Expected option life (years)	5.0	5.0
Interest rate (risk free)	5.51%	5.38 - 6.69%

Volatility was calculated on a monthly basis. Exclusive of one month's data where volatility was 9.9, volatility ranged from 0.0 to 1.4. The Company has never declared nor paid dividends on any of its capital stock and does not expect to in the foreseeable future.

The effects on 1995 and 1996 pro forma net income and net income per share of expensing the estimated fair value of stock options and shares are not necessarily representative of the effects on reporting the results of operations for future years as the periods presented include only one and two years of option grants under the Company's plans.

6. LEASES

The Company leases certain equipment and office space under non-cancellable operating leases. Future minimum rental payments required under the operating leases with non-cancellable terms in excess of one year at December 31, 1996 are as follows:

Year ended December 31,	(in thousands)
1997	$1,198
1998	1,125
1999	580
2000	322
Total	$3,225

Total rent expense under operating leases was approximately $0.9 million, $1.1 million and $1.4 million for the years ended December 31, 1994, 1995 and 1996, respectively.

7. INCOME TAXES

Income before income taxes consists of the following:

	(in thousands)		
	1994	1995	1996
Domestic	$3,512	$4,318	$11,546
Foreign	146	323	572
Total	$3,658	$4,641	$12,118

The provision (benefit) for income taxes for the years ended December 31, 1994, 1995 and 1996 consisted of the following:

	(in thousands)		
	1994	1995	1996
Current:			
Federal	$297	$(107)	$6
State	176	(39)	212
Foreign	31	73	160
Total current	504	(73)	378
Deferred:			
Federal	691	1,563	3,662
State	270	273	578
Total deferred	961	1,836	4,240
	$1,465	$1,763	$4,618

The effective income tax rate differed from the statutory federal income tax rate due to:

	1994	1995	1996
Statutory federal income tax rate	34.0%	34.0%	35.0%
State income taxes, net of federal benefit	7.3	5.8	4.2
Permanent differences	2.0	0.7	0.3
Tax credits	(3.3)	(2.5)	(0.6)
Other	--	--	(0.8)
Effective income tax rate	40.0%	38.0%	38.1%

At December 31, 1994, 1995 and 1996, the Company had alternative minimum tax (AMT) and research and development (R&D) credit carryforwards of approximately $0.6 million, $0.6 million and $0.8 million, respectively, available to offset future federal taxable income. The carryforward period for the AMT credit is unlimited. The R&D credit carryforwards generally expire from 2004 to 2008.

Deferred income taxes at December 31, 1995 and 1996 reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial statement purposes and the amounts used for tax purposes. Significant components of the Company's deferred tax liabilities and assets as of December 31, 1995 and 1996 are as follows:

	December 31, (in thousands)	
	1995	1996
Deferred tax liabilities:		
Software revenue	$(9,303)	$(14,103)
Capitalized software	(213)	--
Depreciation	(142)	(215)
Other	(41)	(71)
Total deferred tax liabilities	(9,699)	(14,389)
Deferred tax assets:		
Deferred state taxes	729	836
License fees	119	--
Vacation accrual	109	380
Other	274	655
Tax credits	725	798
Total deferred tax assets	1,956	2,669
Net deferred tax liabilities	(7,743)	(11,720)
Less current portion	(2,796)	(2,904)
	$(4,947)	$(8,816)

8. SIGNIFICANT CUSTOMERS

During 1994 one customer accounted for 16.8% of the Company's consolidated revenue. This customer also accounted for 12.6% of the Company's 1995 consolidated revenue. In 1995 two other customers accounted for 16.2% and 14.9%, respectively, of the Company's consolidated revenue. In 1996, the Company had three customers that accounted for 14.5%, 11.4% and 10.5%, respectively, of the Company's consolidated revenue.

9. INTERNATIONAL OPERATIONS

The Company's export sales from the United States for 1994, 1995 and 1996 are as follows:

		(in thousands)	
	1994	1995	1996
United Kingdom	$1,515	$1,343	$3,698
Continental Europe	1,409	877	2,017
Other	1,008	114	232
	$3,932	$2,334	$5,947

10. RECAPITALIZATION AND STOCK SPLIT

On December 9, 1994, the Company's Board of Directors declared a fifteen-for-one split of shares of $.01 par value common stock effected in the form of a dividend. This dividend resulted in 7.8 million shares of common stock being issued and outstanding after the split. The par value of the additional shares of common stock issued in connection with the stock split was credited to common stock and a like amount was charged to additional paid-in capital to the extent available, and the remainder to retained earnings.

On July 10, 1996, the Company increased the number of shares of common stock authorized from 9.0 million to 45.0 million shares. The Company's Board of Directors approved a three-for-one stock split in the form of a stock dividend effective on July 10, 1996. The financial statements give effect to both stock splits for all periods presented.

The Board of Directors is authorized, subject to certain limitations prescribed by law, without further stockholder approval, to issue from time to time up to an aggregate 1.0 million shares of Preferred Stock in one or more series and to fix or alter the designations, preferences, rights and any qualifying limitations or restrictions of the shares of each such series thereof, including the dividend rights, dividend rates, conversion rights, voting rights, terms of redemptions (including sinking fund provisions), redemption price or prices, liquidation preferences and the number of shares constituting any shares or designations of such series.

11. SUBSEQUENT EVENTS

Secondary Public Offering: On January 28, 1997, the Company completed a secondary public offering of 1.8 million shares of its common stock at $30.125 per share.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Pegasystems Inc.

We have audited the accompanying consolidated balance sheets of Pegasystems Inc. as of December 31, 1995 and 1996 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pegasystems Inc. at December 31, 1995 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.
ERNST & YOUNG LLP

Boston, Massachusetts
February 24, 1997

Exhibit 23.1

CONSENT OF INDEPENDENT AUDITORS

We consent to the incorporation by reference in this Annual Report (Form 10-K) of Pegasystems Inc. of our report dated February 24, 1997, included in the 1996 Annual Report to Stockholders of Pegasystems Inc.

Our audits also included the financial statement schedule of Pegasystems Inc. listed in Item 14(a). This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits. In our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-09305) pertaining to the Amended and Restated 1994 Long-Term Incentive Plan, the 1996 Employee Stock Purchase Plan, and the 1996 Non-Employee Director Stock Option Plan, of Pegasystems Inc. of our report dated February 24, 1997, with respect to the consolidated financial statements incorporated herein by reference, and our report included in the preceding paragraph with respect to the financial statement schedule included in this Annual Report (Form 10-K) for the year ended December 31, 1996 of Pegasystems Inc.

ERNST & YOUNG LLP

Boston, Massachusetts

March 26, 1997

ARTICLE 5

MULTIPLIER: 1,000

CURRENCY: US DOLLARS

PERIOD TYPE	12 MOS
FISCAL YEAR END	DEC 31 1996
PERIOD START	JAN 01 1996
PERIOD END	DEC 31 1996
EXCHANGE RATE	1
CASH	24,201
SECURITIES	0
RECEIVABLES	14,582
ALLOWANCES	939
INVENTORY	0
CURRENT ASSETS	40,018
PP&E	5,488
DEPRECIATION	(2,453)
TOTAL ASSETS	66,855
CURRENT LIABILITIES	5,654
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	264
OTHER SE	30,206
TOTAL LIABILITY AND EQUITY	66,855
SALES	33,545
TOTAL REVENUES	33,545
CGS	7,452
TOTAL COSTS	7,452
OTHER EXPENSES	16,074
LOSS PROVISION	0
INTEREST EXPENSE	85
INCOME PRETAX	12,118
INCOME TAX	4,618
INCOME CONTINUING	7,500
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	7,500
EPS PRIMARY	$0.28
EPS DILUTED	$0.28

End of Filing